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No. 93-680

In The

Supreme Court of the United States

October Term, 1993

RICHARD W. HUBBARD, Securities Commissioner of the State of Delaware,

Petitioner,

v.

OLDE DISCOUNT CORPORATION,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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December 21, 1993

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REASONS FOR GRANTING THE WRIT

I. THERE IS AN INTER-CIRCUIT SPLIT ON THE ISSUE OF *YOUNGER* ABSTENTION WHERE A PLAINTIFF PURSUES FEDERAL INTERVENTION RATHER THAN PRESENT HIS OR HER FEDERALLY-BASED CLAIMS AS A DEFENSE IN A STATE ADMINISTRATIVE PROCEEDING.

Because Olde Discount Corporation ("Olde") filed this federal action in advance of Delaware's administrative hearing on the charges of securities violations by Olde, the abstention doctrine of *Younger v. Harris*, 401 U.S.

37 (1971), is at issue here. Though the Third Circuit Court of Appeals panel issued three separate opinions on the Federal Arbitration Act ("FAA") preemption issue, it unanimously agreed that *Younger* abstention did not apply. The court of appeals' holding as to abstention has, however, since the filing of the Petition on October 28, 1993, been contradicted by an opinion in another circuit. Recent authority from the Ninth Circuit Court of Appeals contradicts the holding in this case on the issue of *Younger* abstention. In the immediate case, the court of appeals below held that *Younger* abstention is discretionary even when its three elements are present: (1) there is a pending state proceeding that is judicial in nature, (2) an important state interest is implicated in the proceeding, and (3) there is an opportunity for the federal plaintiffs to raise their constitutional claims as a defense in the state proceeding or on appeal. (Pet. App. at 25). However, the Ninth Circuit Court of Appeals, citing *Ohio Civil Rights Commission v. Dayton Christian Schools, Inc.*, 477 U.S. 619 (1986), and *New Orleans Public Service, Inc. v. City Council of New Orleans*, 491 U.S. 350, 369 (1989), has held that federal abstention is "required" when all three elements of *Younger* abstention are present. *Nevada Entertainment Industries, Inc. v. City of Henderson*, Nos. 92-17054, 93-15052, 1993 WL 440224 (9th Cir. Nov. 2, 1993) (per curiam). According to the Ninth Circuit, the respondent in a state license revocation proceeding may not obtain federal intervention in a § 1983 action rather than defend itself on the state charges and pursue an available state judicial appeal. Thus, in addition to the reasons set forth in the Petition, this split in the circuits militates in favor of granting certiorari.

II. THIS CASE PRESENTS A NOVEL PREEMPTION QUESTION OF GREAT IMPORTANCE IN THE AREAS OF FEDERALISM AND ARBITRATION.

This case presents a federal preemption question of critical importance to state sovereignty: whether private parties are empowered to contract away the statutory remedies of a state regulatory agency. The court of appeals below held that the Federal Arbitration Act preempts a state securities commissioner from ordering restitution with respect to any dispute between private parties who have agreed to submit their disputes to arbitration.[1] If arbitration agreements are deemed to preempt state regulatory actions seeking restitution in the public interest, however, a major function of state attorneys general in the area of consumer and investor protection may be negated through private contract. For this reason, the North American Securities Administrators Association and the National Consumers League have filed a brief as *amici curiae* supporting this Petition. The ramifications of the court of appeals' decision in reducing the ability of states to sanction fraudulent commercial transactions within their borders are likely to become more profound over time as arbitration agreements proliferate among various types of consumer transactions.

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[1] The court of appeals' holding was based on two distinct theories. Judge Greenberg affirmed the district court's order on a preemption theory, but Judge Rosenn concurred instead on a theory of contract law, finding no preemption.

Respondent asserts that the decision below merely reaffirms well-settled authority and that this case presents no novel issue of law. However, the three-way split of the court of appeals panel manifests the complexity of the preemption issue. Indeed, Judge Greenberg (the only panel member agreeing with respondent's preemption theory), began his opinion with this statement:

> This case presents a *novel question* of the relationship between a contracting party's right to enforcement of an arbitration agreement under the Federal Arbitration Act, 9 U.S.C. §§ 1-16 (FAA), and a state's interest in pursuing a remedy of rescission in an administrative proceeding.

(Pet. App. at 3, emphasis added). Judge Nygaard, in dissent, placed even more importance on the court's preemption holding:

> I believe that the opinion of the court unlawfully transfers the authority vested in the Commissioner to private parties. Thus, the boundaries of what the Commissioner, or any other agency with enforcement powers, can or cannot do is not defined by statute, but is limited by the agreements of private individuals.

(Pet. App. at 43). The court of appeals thus viewed the preemption issue here to be distinct from prior arbitration cases where states sought to regulate the arbitration process itself and discriminate against it. *See, e.g., Securities Industry Ass'n v. Connolly*, 883 F.2d 1114 (1st Cir 1989), *cert. denied*, 495 U.S. 956 (1990).

The issue here is whether the federal policy favoring arbitration has any limit, and if so, where that limit is to be drawn. If the respondent's argument is taken to its logical extreme, the Delaware Securities Division would be preempted from bringing any administrative proceeding against Olde on the basis of the Engelhardts' allegations of fraud because the case would involve the same facts and circumstances as those that would be presented at an arbitration between the private parties. If the administrative proceeding were merely a "guise" for a private civil claim, as the respondent asserts (Opp. Br. at i), one would expect that the district court would have enjoined the proceeding. Olde had in fact moved the district court to enjoin the entire administrative proceeding, but the court declined to do so. (Pet. App. at 75). The district court, in its attempt at line-drawing, has thought it appropriate to allow the proceeding to go forward but without one of the State's statutory remedies. This case thus presents the question of where the federal policy favoring arbitration reaches its limit when it runs directly contrary to federalism concerns. It is a critical question that has, to date, been unresolved by this Court.

III. THIS CASE MAY BE DECIDED ON LEGAL PRINCIPLES WITHOUT REGARD TO DISPUTED FACTS.

This appeal may be decided on legal principles without regard to the facts that are in dispute. Respondent's Brief in Opposition relies heavily on alleged findings of fact that were never made by the district court. Olde asserts that the prosecutor acted in bad faith; he made

"extortionist" threats; and he was an agent of the investors working solely for their interest.[2]

Although the posture of this case makes some of the preliminary factual determinations by the district court of questionable validity, the basic findings that frame the two legal issues are undisputed. Two Delaware investors, the Engelhardts, entered into several securities transactions with Olde. As part of that relationship, they signed a pre-dispute arbitration agreement. They subsequently complained to the Delaware Securities Division and alleged that fraudulent misrepresentations were made. The Securities Division investigated and sent Olde a copy of a draft notice of charges. Settlement discussions took place but then broke down. The notice of charges was issued, and the Securities Division sought rescission for the Engelhardts as one of the remedies in the prayer for relief, which also sought a fine and license suspension or revocation. Each remedy was authorized by Del. Code Ann. tit. 6, § 7325(b). Olde responded by filing this action

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[2] Contrary to the respondent's suggestions, the district court made no finding of bad faith or extortionate conduct by the prosecutor. Although respondent argues today that Tupman made "extortionist" threats at their settlement meeting on August 5, 1992 (Opp. Br. at 5), in its August 5 letter to Tupman immediately after that meeting, its counsel (Bruce Campbell) thanked him for "the many courtesies extended" and stated "[w]e understand that you cannot provide legal counsel to the Engelhardts. . . . " (App. 7a, 5a). Mr. Tupman represented the Engelhardts in the district court only because of Del. Code Ann. tit. 29, § 2504(9), which creates a mandatory duty for the Delaware Department of Justice to represent witness-victims who are sued in connection with their role as witnesses for the State.

in federal district court, arguing that the Federal Arbitration Act preempted the imposition of Delaware's restitution remedy.

Those are the only relevant facts which this Court need consider in applying controlling legal principles. This Court's guidance on the law is needed to ensure that a great intrusion on state sovereignty is not undertaken on the basis of the divided, misguided decision below.

CONCLUSION

For the above-stated reasons, and those in the Petition, this Court should grant the Petition for a Writ of Certiorari.

Respectfully submitted,

CHARLES M. OBERLY, III
Attorney General of the
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December 21, 1993

APPENDIX

The attached document was part of the district court record below. (D.I. 6, Exhibit J).

OLDE DISCOUNT

CORPORATION

Member SIPC
LEGAL DEPARTMENT

August 5, 1992

VIA FACSIMILE

W. Michael Tupman, Esq.
Deputy Attorney General
State of Delaware
Department of Justice
State Office Building
820 French Street
Wilmington, Delaware 19801

Re: Case No. 91-07-01

Dear Mr. Tupman:

Thank you for taking the time to meet with Randy Mudge, Rich Tucker and me today. Since the issues are very important to all involved, I want to memorialize the points which we expressed in our discussions.

We understand that the Attorney General's Office agrees that it is in the best interest of all parties that the matter be resolved by OLDE Discount making a payment, in the amount of $15,000.00, to the Delaware Investors Protection Fund, and that the State of Delaware would close the files in this matter, and further, the State would not open or institute any proceedings in the captioned matter. The only disagreement, or sticking point, to resolving this matter appears to be your assertion that OLDE's offer to the Engelhardts, in the amount of

approximately $20,000, "may not be adequate" and that rescission (as opposed to our offer of restitution), in the amount of approximately $52,000 would be "more fair" to the Engelhardts. We believe that the offer which we have made to the State of Delaware and to the Engelhardts respectively is both generous and reasonable under the circumstances and is fully supported by Delaware law.

Regardless of the strengths (or weaknesses) of the merits of their claim, OLDE's offer to compensate the Engelhardts is more than simply a token settlement. The offer of compensation to the Engelhardts is complete restitution for all of the losses allegedly caused by Donohoe while their SNFS stock was held at OLDE Discount. As we explained, the $20,375 offer reimburses the Engelhardts for the full depreciation in the value of their SNFS stock calculated by the cost of their purchases less the market value of the stock on September 6, 1990, the date when the Engelhardts transferred their SNFS stock out of OLDE Discount. At least by that date (and probably earlier), the Engelhardts were fully aware of their claim concerning Donohoe and their putative unhappiness with OLDE. After September 6, 1990, the Engelhardts made a new and independent investment decision to keep (*not* sell) their SNFS stock. On that date, the Engelhardts turned pro active making their own decisions without any influence from either Donohoe or OLDE Discount. They also assumed responsibility for their independent decisions. Surely, OLDE Discount cannot (and should not) be held financially responsible virtually as a guarantor of the investment *after* the Engelhardts removed OLDE Discount's involvement by transfer of the stock out of OLDE. To hold otherwise

would allow the Engelhardts to "play the market" at OLDE Discount's expense. The Delaware Securities Act ("Act") does not contemplate, let alone require such an unreasonable and punitive approach. Moreover, our offer of complete restitution is expressly embraced by the Act. *See* Section 7325(b).

As with any contested matter, the allegations involving Mr. Donohoe are problematical. However, regardless of the strengths or weaknesses of the State's proposed case against Donohoe, we believe that the allegations involving OLDE Discount are tenuous, at best. Rather than discuss the specifics of the allegations as we did in our letter dated June 25, 1992, we share with you two additional observations. First, we note that the nature of most of Donohoe's alleged wrongdoing is not causally linked to the Engelhardts' losses. For example, the allegations regarding disclosure of market-maker status, commissions charged and whether the transactions were "solicited" or "unsolicited" do not appear to have any causal relationship to any claimed losses. Secondly, and perhaps more importantly, many of the allegations regarding Donohoe occurred well-after the Engelhardts transferred out of OLDE their SNFS stock. *See e.g.* State's proposed notice paragraphs 20 and 21. Like our assessment of financial responsibility discussed above, we believe that OLDE Discount cannot (and should not) be held accountable for events which occurred *subsequent* to the September 6, 1990 stock transfer date.

Notwithstanding our views on the overall merits, we remain willing to resolve this matter by again urging that you accept our generous offer of settlement. If the

Engelhardts believe that this restitutionary offer is unacceptable, the State should nevertheless accept the balance of our offer and bifurcate the State's public interests from those of individual private citizens (the Engelhardts).

Apparently, you have some dilemma as to whether you can or should bifurcate the State's public interest position from the private interests of the Engelhardts because you believe that you may have some obligation to administer rescission as provided in Section 7325(b) of the Delaware Code, as amended. We believe that you have no such obligation and may have misperceived the role of the state. *The Engelhardts have opportunities to redress any alleged improprieties.* If the Commissioner's decision under Section 7325(b) was the only remedy available to the Engelhardts, then the State might have some valid concerns about bifurcation, but that is not true in this matter, since the Engelhardts have access to both the arbitration process and state and federal courts to redress any purported wrongdoing.

We urge that the Engelhardts be apprised of our offer to pay them $20,375 in settlement of their dispute with OLDE Discount arising out of their purchase of SNFS stock, and that such offer will remain open for a period of ten days, from the date of this letter. In the event that the Engelhardts refuse our offer then we ask that their attorney, or the Engelhardts themselves, directly advise us that the offer is declined, and they may take whatever action they deem necessary, either in court or in arbitration.

As you know, we have had a nagging concern in our discussions with the State because we do not know

whether the Engelhardts are represented by counsel. We understand that you cannot provide legal counsel to the Engelhardts and therefore we are unable to discern whether the Engelhardts have had the benefit of counsel in evaluating our offer. We believe that counsel would be able to apprise the Engelhardts of the relative merits and risks of litigation [sic] this matter with OLDE Discount.

If the Engelhardts are represented by counsel, we would like to know the identity of that counsel, so that we may directly communicate our offer to their counsel. In the event that they are not represented by counsel, we suggest that they consider obtaining such representation, in order to evaluate and discuss our offer to them.

Finally, in the event that our discussions do not produce a mutually agreeable resolution of this matter, there are a couple of issues which we believe you should consider. As above, these issues do not have as their underpinning any analysis of the respective positions of the State, OLDE, the Engelhardts or Mr. Donohoe.

The application of amended Section 7325(b), in the instant matter, would constitute the imposition of *ex post facto* penalties in violation of the "Due Process Clauses" of the Constitutions of both the United States and the State of Delaware. *See Weaver v. Graham*, 450 U.S. 24, (1981); *In the Matter of the State of Delaware for a Writ of Mandamus*, 603 A.2d 814 (Del. 1992). The acts underlying the State's allegations in this matter, occurred prior to the August 16, 1991 effective date of amended Section 7325(b). Because of the serious concerns about the applicability of this provision, in the instant matter, Section

7325(b) should play a *de minimis* role in the State's decision to settle this matter.

In addition to being *ex post facto*, the application of Section 7325(b) violates the separation of civil and criminal proceedings in the administration of justice, also in violation of due process. We are aware of the previous position of Commissioner Hubbard, (e.g. in the Hibbard Brown matter), wherein he distinguished between the remedial and penal nature of his decision-making process, and we submit that such a distinction is inappropriate in a case where the Commissioner is determining penal and remedial sanctions simultaneously in the same matter. Once penal sanctions are being considered in any single matter, then the matter is penal in nature (for all purposes) and not remedial or civil in nature. Therefore, predicating settlement on both the penal and civil aspects of this matter would be tantamount to using the threat of criminal (penal) litigation in order to settle civil (remedial) litigation, a questionable approach under any state's professional conduct rules. *See In re Ridgely*, 48 Del. 464, 106 A.2d 527 (1954).

Finally, application of Section 7325(b), as you propose would violate the "Supremacy Clause" of the United States Constitution. See *S.I.A vs. Connolly*, 888 F.2d 1114 (1st Cir. 1989) *cert. denied* 110 S. Ct. 2559. See S.I.A. vs. Lewis, 751 F. Supp. 205 (S. D. Fla. 1990.)

OLDE Discount believes that its internal control procedures and supervisory compliance procedures of its sole office in Delaware were at least consistent with custom and practice in the securities industry and all applicable regulations and were properly and fully implemented and

enforced. Absent direct feedback from our customers, there is absolutely no way any securities firm can learn, for example, whether orders which were allegedly solicited were marked "unsolicited." As you know, the Engelhardts conveyed no such advice to OLDE Discount. If we are unable to resolve this matter in a way which is fair to all parties, OLDE must weigh the seemingly unfair costs of doing business in Delaware (i.e. an extraordinary payment in excess of $50,000 to customers who have never complained to us and have attempted to play the market at our expense) against the relatively insignificant profitability of a very small market. Such a harsh choice sends the wrong message to companies doing business in the State. We hope and trust that you will consider this letter in the spirit in which we have conducted all of our dealings with you to facilitate a prompt, fair resolution of this matter.

We urge you to accept our offer of settlement and await your response. We appreciate the many courtesies extended.

Sincerely,

OLDE DISCOUNT
CORPORATION

Bruce A. Campbell
Corporate Attorney